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Reporting Information to Management Under Conditions of Inflation

Report on a Forum

by Francis J. Walsh, Jr.

Director, Financial Management and Accounting Research

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Attendance List

Mr. Douglas Bender, C.P.A.
Partner
Price Waterhouse & Company

Dr. Betty Bock
Consultant
The Conference Board, Inc.

Mr. W. Warren Brown
Assistant Comptroller
American Telephone & Telegraph Co.

Mr. Henry Gunders, C.P.A.
Co-Chairman and Deputy Senior Partner
Price Waterhouse & Company

Mr. Edwin P. Harkins
Consultant
The Conference Board, Inc.

Mr. Thomas J. Hoeppner
Assistant Controller and Director of
Financial Planning
General Foods Corporation

Mr. R.G. Jones
Associate Comptroller
The Procter & Gamble Company

Mr. Herbert C. Knortz
Executive Vice President
and Comptroller
ITT Corporation

Mr. David K. Leak
Vice President
Federal-Mogul Corporation

Mr. Conlyn Noland
Assistant Comptroller
E.I. du Pont de Nemours & Company

Mr. William C. Norby, C.F.A.
Duff and Phelps, Inc.

Mr. Firmin A. Paulus
Director of Corporate Accounting
Development
The Dow Chemical Company

Mr. Louis G. Peloubet
Controller
Union Carbide Corporation

Mr. Robert Ripp
Director of Financial Analysis
IBM Corporation

Mr. Frank W. Schiff
Vice President and Chief Economist
Committee for Economic Development

Mr. Edward Shahinian
Director of Financial Reporting
IBM Corporation

Mr. Francis J. Walsh, Jr.
Director, Financial Management
and Accounting Research
The Conference Board, Inc.

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THE CONFERENCE BOARD, INC.
845 Third Avenue, New York, N.Y. 10022
THE CONFERENCE BOARD OF CANADA*
25 McArthur Road, Ottawa, Ontario, K1L-6R3, Canada
THE CONFERENCE BOARD, INC.
Avenue Louise, 207 Bte 5, B-1050 Brussels, Belgium

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INTRODUCTION

THE MONTH OF SEPTEMBER, 1979, witnessed a significant event in the history of accounting. At that time, the Financial Accounting Standards Board issued its now famous Statement No. 33, "Financial Reporting and Changing Prices." This statement was unusually important because for the first time in history it authorized a departure from the traditional, historical cost basis of accounting. It must be noted that the FASB's pronouncement prescribed this break with tradition only in the form of *supplemental* disclosures of certain financial statement items, and that the requirement applies only to a relatively small number of very large corporations. Nevertheless, it was an official recognition that inflation has seriously impaired the usefulness of conventionally prepared financial reports in that these traditional reports do not adequately inform investors of the effects of rising prices on the firms to which they have entrusted their savings.

An important point that should be borne in mind in connection with FAS 33 is that it applies only to the annual reports of corporations that are distributed to investors and to the public. It does not apply in any way to financial information prepared for the benefit of decision makers within the managements of companies. As far as anyone knows at present, few business enterprises have gone beyond the strict requirements of FAS 33 by preparing inflation-adjusted financial information for the use of their internal managements.

Nevertheless, some executives, accountants and economists have become increasingly alarmed over the lack of inflation-adjusted information that has so far been made available on a regular basis to the managers of U.S. industrial corporations. These concerned observers believe that corporate decision making based entirely on historical cost financial information is bound to be erroneous. At the microeconomic level, for example, they say it can lead to unwise corporate dividend policies or to executive compensation arrangements that reward economically unsound actions. At the macroeconomic level, they believe that conventional accounting rewards the retention of obsolete plants and equipment rather than encouraging investment in newer, more productive facilities. Thus, they feel that the competitive position of U.S. industry in world markets will suffer as a result of accounting practices that fail to show managements what inflation is doing to their enterprises in real terms.

Some of these concerned executives and accountants suggested to The Conference Board that the time had come for a serious discussion of the problems of management decision making under inflationary conditions. A closely related concern has to do with the kinds of data that managements need in order to make economically sound business decisions during inflation.

Responding to these urgings, the Board convened a forum in New York City on June 24, 1981, to examine these questions. A small but highly knowledgeable group of persons was invited. They were known to be interested in the problems and, in some cases, had done some work in their own companies to deal with them. The accompanying box lists the forum participants.

The purpose of this publication is to summarize, for the benefit of Associates of The Conference Board, the thoughts expressed by the forum participants. This paper is not a report of proceedings in the usual sense. Rather, it is intended to be a concise report of the concerns and recommendations of the members of the forum with the end in view of stimulating further thinking, discussion and experimentation on the part of the entire business community.

SUMMARY OF ISSUES AND PROBLEMS

The first contributor to the forum was Mr. William C. Norby, C.F.A., consultant to Duff and Phelps, Inc., Chicago, Illinois. Mr. Norby is well-known to the other participants in the forum because of his long-standing association with accounting issues from the viewpoint of the financial analyst, and his specialized research and writing on inflation accounting. Mr. Norby agreed to present a paper on which the issues and problems of this meeting would be focused.

He stated that the idea for the forum originated with the question: "How can companies use the inflation-adjusted accounting data now required by FAS 33 for management-control and decision-making purposes?" Later, as thinking progressed, the broadened purposes of the meeting were defined as follows:

(1) To consider how management behavior is affected by an inflationary environment;
(2) To examine whether financial data used for

management decisions need to be adjusted for inflation; and, if so, what types of data and how adjusted;
(3) To consider whether research is needed on adjusting internal financial data for inflation; and, if so, to advise on the design and execution of a research project.

With regard to purpose (1), managements have responded to inflation in several ways, notably by more widespread application of the last-in, first-out (LIFO) method of accounting for the flow of inventory costs; however, Mr. Norby observed that a considerable percentage of companies still use the first-in, first-out (FIFO) method. Some of the other forum participants agreed with this observation and expressed surprise at the survival of FIFO in an inflationary climate because this approach matches older, less inflated inventory costs against current inflated revenues and thus tends to overstate net income.

Mr. Norby also said that many companies incorporated an inflation factor in planning capital expenditure projects and for preparing financial projections. Some other forum members believe this practice is now quite common. And, he pointed out that the 1980 annual reports of some companies have shown an awareness of the inroads of inflation on the management decision-making process in various ways. Reports of the following companies were cited as examples:

American Can Company
American Standard, Inc.
Beatrice Foods, Inc.
Black & Decker Manufacturing Co.
TRW, Inc.

Regardless of how managements actually behave in response to inflation, Mr. Norby expressed the thought that this forum should address itself to the question of what strategies managements *ought* to adopt under inflationary conditions. He offered the following five possible corporate goals as a basis for discussion:

(1) Maintain operating capability in real terms; that is, maintaining the productive capacity of the business.
(2) Secure adequate and safe financing.
(3) Earn an adequate rate of return on the *current value* of the assets after providing for all current costs. This rate should be risk-adjusted and it should use as a base the average yield on long-term government bonds, expressed in nominal terms.
(4) Increase inflation-adjusted net income and dividend payouts at least as rapidly as the inflation rate, so as to maintain the stockholders' real incomes.
(5) Maintain, if possible, the real value of the company's stock in the marketplace.

He acknowledged that these goals are difficult as a composite program, but suggested that their attainment depends partly on whether inflation is anticipated or unanticipated (e.g., the period from 1978 through 1980 as against the 1973-1975 period).

In order to attain these goals, Mr. Norby suggested that management might consider the following actions, individually or in combination:

(1) Engage in aggressive pricing to the extent that competition will allow.
(2) Adopt more effective inventory controls.
(3) Improve pretax profit margins.
(4) Change financial measurement systems to report "real" results.
(5) Raise hurdle rates for new capital expenditure projects.
(6) Divest units of the business that do not pull their weight in an inflationary environment.
(7) Increase leverage by operating with a greater percentage of borrowed funds.
(8) Change dividend policy to reflect the reality of inflation.
(9) Evaluate potential acquisitions on the basis of inflation-adjusted data, particularly with regard to valuation of the acquired company's assets at current value.

The second broad purpose of this meeting—examination of the question of whether financial data used for management decision making needs to be adjusted—was addressed next by Mr. Norby. He pointed out that, as a preliminary step, the forum participants might consider the extent to which FAS 33 data is useful for management information purposes. But, he emphasized, the purpose of such an examination should not be to argue the merits or shortcomings of the methods prescribed by FAS 33.

The forum members agreed at this point that the most realistic approach to inflation accounting is the current-cost method (see box). Although FAS 33 requires that companies also prepare adjusted data using the constant-dollar method (see box), the consensus of the members was that this latter approach is less useful for internal management information purposes.

Mr. Norby then went on to point out the following attributes of the current-cost accounting method:

(1) By modifying the values attributed to inventories and long-lived assets, the income statement is made to reflect the amounts required to sustain operating capacity before any dividends are distributed.
(2) Although current cost tends to reduce operating earnings on the income statement, it increases the

The Current-Cost and Constant-Dollar Methods of Calculating Inflation Adjustments

Current-Cost Accounting

FASB Statement No. 33 defines Current-Cost Accounting as: "A method of measuring and reporting assets and expenses associated with the use or sale of assets, at their current cost or lower recoverable amount at the balance sheet date or at the date of use or sale."[1]

Current-cost accounting, unlike constant-dollar accounting, makes no attempt to retain its tie to historical dollars. The philosophy of current-cost accounting, declares, in effect, that the dollars expended at some point in the past have no relevance in the preparation of a present-day financial statement during an inflationary period. According to this view, the only relevant numbers are the dollars that would be expended if an asset were to be acquired on the balance sheet date. Proponents of this view believe that any other method of valuation is not economically realistic during inflation.

Furthermore, current-cost accounting regards the effects of inflation on an enterprise not in terms of changes in the general price level, as in the case of constant-dollar accounting. Rather, it concentrates on the price-level changes of the specific commodities or assets with which the individual firm is concerned.

The current-cost technique requires the selection of appropriate methods of determining curent costs of the items to be measured. FASB Statement No. 33 suggests internally or externally generated price indexes for the class of goods or services being measured; references to current invoice prices; vendors' price lists or other quotations or estimates; and standard manufacturing costs that reflect current costs.

Constant-Dollar Accounting

FASB Statement No. 33 defines constant-dollar accounting as: "A method of reporting financial statement elements in dollars each of which has the same (i.e., constant) general purchasing power. This method of accounting is often described as accounting in units of general purchasing power or as accounting in units of current purchasing power."

The important element in this definition for the purposes of this discussion is the concept of reporting in dollars of the same general purchasing power. Constant-dollar accounting differs fundamentally from the current-cost accounting approach in this emphasis on changes in general purchasing power, rather than on changes in prices of specific commodities or groups of commodities.

[1]Statement of Financial Accounting Standards No. 33, "Financial Reporting and Changing Prices," September, 1979. Copyright (c) Financial Accounting Standards Board of the Financial Accounting Foundation, High Ridge Park, Stamford, Connecticut 06905.

values of certain assets on the balance sheet (calculated on the basis of cost, which may not be market value). Although unrealized, such appreciation is economically significant.

(3) Current cost does not adjust for so-called purchasing-power gains or losses on monetary assets. But the economic gains from incurring debt are reflected in the appreciation of long-lived assets.

(4) Cash flow is not affected by current-cost accounting. Inflation changes the allocation of expenditures between replacement of old facilities and investment in new ones. This phenomenon can give some insight into the effects of inflation on a company.

"Bottom line" numbers that are common indicators of a company's performance are the best way to give readers of financial reports a comparison of company performance with inflation-adjusted "real" results, Mr. Norby suggested. Adjustments of the entire balance sheet and income statement are not desirable, in his opinion. For example, the following summary measurements can be adjusted, using the CPI or the GNP deflator:

(1) Current-cost earnings per share;

(2) Total earnings per share, including holding gains;

(3) Stockholders' equity per share, including revaluations resulting from applying current-cost adjustments;

(4) Dividends per share;

(5) Current-cost return on capital, including revaluations;

(6) Operating margin on a current cost basis.

At this point, there was a discussion of which commonly used measure of inflation is most useful for the purposes of accounting adjustments. Mr. Norby stated that the GNP deflator probably produces the most realistic results for business but that the CPI (Consumer Price Index) is more popular. Mr. Herbert C. Knortz, of ITT Corporation, said that the CPI is probably not too accurate for evaluating his company's business. But since this is the index chosen by the FASB for Statement No. 33 adjustments, it is probably better to go along with it for the sake of consistency. Mr. Knortz added, and several other participants concurred, that in the long run it probably does not make too much difference which index is used. The important thing is to recognize the general trend of worldwide inflation.

Industrial Inflation Accounting Index

A feature of Mr. Norby's presentation was a report of a statistical study that he has conducted. This study is an aggregation of financial statement data covering 100 industrial companies in 23 different industries for the period 1973-1980. The principal thrust of the study is to show certain key financial indicators for the group of companies *on an inflation-adjusted basis* for the period under study.

The inflation-adjusted data were derived from published financial statements of listed corporations based on FAS 33 disclosures, on replacement cost disclosures required for the 1976-1979 period by the SEC's Accounting Series Release No. 190, and on estimates for earlier years. These data and the ratios developed from them are reproduced in the appendix beginning on page 11.

The statistical study is significant because it demonstrates the kind of analysis of the effects of inflation that can be made simply with readily available, published information. Mr. Norby pointed out that, even with the acknowledged shortcomings of FAS 33 and ASR 190 computations, certain messages for company managements are clearly evident from his analysis:

(1) The profit margin is the key control point for contending with inflation.
(2) Improved asset turnover rates can reduce the effects of inflation on capital investment requirements.
(3) Increased leverage in the capital structure, while theoretically a measure for combatting inflation, has not been adopted to any extent by most companies, partly because interest coverage ratios have declined due to inflationary increases in interest rates.
(4) Return on investment based on current-cost income is far below ROI calculations based on historical-cost information. However, it is higher when unrealized holding gains are included.
(5) Although inflation adjustments do not affect cash inflows, they do reclassify cash outflows.
(6) The test of company performance in an inflationary climate is how well the bottom line results (on an inflation-adjusted basis) hold up vis-á-vis the rate of inflation.

Applying these tests, Mr. Norby concluded that, in the aggregate, the companies in his study have done reasonably well in keeping their shareholders even with inflation. However, the results fall short of the theoretical goals he suggested at the outset.

EXAMPLE OF A COMPANY APPROACH: FEDERAL-MOGUL CORPORATION

Federal-Mogul Corporation of Southfield, Michigan, has made substantial progress in developing inflation-adjusted data for management decision-making purposes. This manufacturer of precision parts, principally for the automotive and aerospace industries, is listed on the New York Stock Exchange and had 1980 sales amounting to $721 million. Its 40 manufacturing plants and 60 warehouses serve customers in nearly all free world countries. The company was represented at the forum by Mr. David K. Leak, Vice President.

Mr. Leak stated that his company has for many years operated an internal reporting system to assist management in the operation of its various lines of business. In recent years, however, high inflation has necessitated a complete overhaul of this system. This renovation sought to overcome the following problems:

(1) *Hidden costs*—During periods of rapid inflation, the historical-cost method of accounting significantly understates cost of sales when the FIFO method of inventory costing is used. In addition, the amortization cost of any significant nonmonetary, long-lived asset may also be seriously understated.
(2) *Hidden investments*—The historical cost method distorts the balance sheet values of assets. The carrying value of a LIFO inventory is unrealistically low, and so are the measurements assigned to long-lived nonmonetary assets and liabilities.
(3) *Undermining of financial scoring systems*—Because of these hidden costs and hidden investments, the analytical methods commonly used to gauge the progress of an enterprise become distorted, and possibly useless, during inflation. Examples of such measurements are: sales growth, return on sales, earnings per share, return on assets employed, and return on equity.

The manager of an old plant, who remains satisfied with the same historical-cost return on assets that he generated 10 years ago, is unwittingly liquidating his business because he is not producing sufficient earnings (or cash flow, either) to replace his equipment when it wears out.

Cash flow is the lifeblood of any business. When prices are relatively stable, historical-cost accounting reports and the analytical methods based on them show a reliable approximation of cash flow over time. But inflation destroys the relatinship between historical cost-based data and cash flow.

(4) *Distortion of sales and earnings data*—Managers who are involved with profit centers must rely on a large amount of detailed sales, cost, expense and variance data. Inflation has seriously diminished the value of this information if it is based on historical dollars.

Mr. Leak stated that a business must learn to deal with the above problems to survive in a climate of high in-

flation. In his company, the principal thrust along these lines is in the management and control of assets and in making managers aware of hidden costs and hidden investments. To this end, the following three general principles are observed:

(1) Management reports must be based on current, not historical, costs.
(2) Monitoring of cash flow is vital and management has the duty to ensure that assets are well-controlled and fully utilized.
(3) Reports to management must be designed to highlight the hidden costs as well as the more obvious effects of inflation.

In observance of these general principles, Mr. Leak went on to explain briefly the steps that have been taken to implement them.

Current-Cost Reporting

The company has adopted LIFO for all locations in order to provide a cost-of-sales valuation that approximates current costs. Also, LIFO reserves against balance-sheet carrying amounts were deleted from profit-center management reports. This change helps to keep inventory valuations close to current costs on these reports.

A computerized accounting system for plant and equipment accounting has been installed. All profit-center managers now have available both the historical cost and current cost of facilities, plus related depreciation information.

Management of Productive Capacity

Federal-Mogul Corporation is a capital-intensive enterprise and its management controls are designed to make sure that its facilities are fully utilized. Management is so concerned with this objective that labor cost controls are considered to be of secondary importance.

The control process starts with a financial evaluation of the business broken down into product line and market segments. The key measure is return on net assets (RONA) where:

Return = Pretax plant profit before depreciation expense and after selling and distribution expenses.

Net assets = Accounts receivable plus inventories (at current cost) plus productive facilities used in the segment (at current cost before depreciation), less trade payables.

This evaluation requires the allocation of all plant costs to business segments. Another complication is that some products and parts are sold in more than one market. Therefore, the company found it necessary to develop full cost and investment standards by part numbers to permit reassembly of these data according to various market segments.

Mr. Leak said that, when first instituted, the return on net assets evaluation of business segments created a few surprises for management. For example, some segments that were thought to have "fat" profits did not look so profitable when it was observed that a very high capital investment was required to generate these profits. The opposite was true for some segments that were formerly believed to have low profits.

Naturally, this measurement approach, when first instituted, was not universally accepted. But it has proved to be a valuable tool for top management in helping to focus strategic planning on those business segments that were doing the most for the company in generating profits. At the plant level, it has helped by quantifying the effects of management decisions concerning machine efficiency, surplus capacity, set-up time, and expansion or contraction of certain activities. Over time, management has shifted its focus from profit margins to return on net assets as the standard for daily decision making.

Management of Inventories

The shift in emphasis to the return on net assets measurement has also had the beneficial effect of directing local managers' attention to the maintenance of inventory investments at more economical levels. Also of great importance in the control of inventories is the company's effort to reduce set-up times. Mr. Leak stated that this effect has reduced the level of economic manufacturing quantities, with a corresponding reduction in inventory investments.

Receivables and Payables

As indicated above, Federal-Mogul Corporation's return on net assets formula requires the identification of accounts receivable and accounts payable with product lines and market segments. A side benefit from this development is increased local management interest in improved purchasing methods, as well as invoicing and collection procedures. Mr. Leak stated that the savings resulting from reduced investments in working capital items justified the company's investment in the computer capability that made the accounting refinements possible. He also reiterated that the reporting systems and improved controls over assets were designed, above all, to optimize cash flow. And, he added, better cash flow produces better performance figures under any system of measurement.

Federal-Mogul Corporation Approaches to Inflation Adjustments in Management Reports

Standards are set annually for product costs, selling prices, and the purchase prices of all the major components of cost. Subsequently, all purchases are charged to expense or inventory at the budgeted standard price with any residue going to a "cost/price" variance account. Thus, the cost of inflation is isolated for reporting as goods or services are purchased.

Standard variable costs are adjusted whenever inflation causes an increase of 3 percent or more in total cost. Because purchases are charged to inventory at the budgeted standard price, sales are dual-costed at current and budgeted standards. Cost of sales is reported at current cost, inventory is relieved at budgeted cost, and the residue is reported as a "standards change" variance. Of course, this also means that variances are expressed in constant dollars through the year, which is more helpful to management than variance reporting which represents a combination of inflation and operating deviations.

Sales also are dual-priced at budget and current prices, providing a price deviation amount for reporting purposes. A manager who receives an earnings statement which indicates the changes in selling prices, purchase prices, and standards changes can tell at a glance if price increases are keeping up with cost increases and whether standards are properly maintained. Other variance accounts are reported in constant dollars and are accurate measurements of operating deviations. The measurement of price increases also indicates the inflation in accounts receivable. Year-end inventories are dual-priced at budgeted and current standards, which provide accurate tracking of the change in unit inventories and a realistic inflation index for inventory.

Period costs are reported in the same manner as variable costs, but are detailed in the usual section of the statements. Price/cost variances are computed and reported. Operating period cost variances represent the cost of underutilization of productive capacity or a deviation in unit purchases. All variances are appropriately detailed in subreports in a manner which allows the management team to assess its operation.

The company also tracks and reports cash flow on a quarterly basis. Its management feels that a simple, operating cash flow statement is the best measurement of overall operating results during periods of high inflation. A FIFO company has high theoretical cash flow from earnings, but must "invest" much of it into constantly inflating inventories. A new plant generates more cash flow from depreciation than an old plant. Cash flow may be an excellent measuring tool; however, it is virtually useless to the operating manager who wants to identify specific problems in his operation.

Reporting

Returning to the subject of inflation accounting, Mr. Leak stated that, since 1975, the company's internal income statements and certain balance-sheet items have been adjusted to reflect current costs. Some details as to the approaches used are outlined in the accompanying box.

Summary

In summing up his presentation, Mr. Leak stated that high inflation has caused considerable changes in the management of Federal-Mogul Corporation. Management reports have been converted from the historical cost basis to current costs; emphasis has been shifted from return on sales to return on net assets and to improving cash flow; and the reporting system has been redesigned to separate the effects of inflation from operating variances. Management believes that the ability to maintain or expand market share, with products priced to give an acceptable return on the company's current-cost investment, is the true test of the long-term health of the company and of any business segment. The entire accounting, reporting and planning system has been developed to measure actual performance against that test.

OTHER VIEWPOINTS

Several other forum members reported the experiences and conceptual approaches of their companies in trying to manage effectively during inflationary times. For example, Mr. Herbert C. Knortz, Executive Vice President and Comptroller of ITT Corporation, explained how his firm, some time ago, undertook capital expenditures in excess of certain inflation-adjusted guidelines. Although the situation has eased in recent years, the problem of determining the proper size of the total capital expenditures budget during inflationary times has continued to interest the company's management.

Mr. Knortz believes that conventional financial statements are not much help to corporate management in this respect. Instead, he points to the need for a new financing document that will show how much is available in discretionary funds. Modifying the conventional sources and applications of funds statement format, and introducing depreciation on the basis of current costs, Mr. Knortz presented the analysis reproduced as Exhibit 1. Using published annual report data, this document shows clearly how much of an increase or decrease in debt was necessary to finance the firm's activities in 1980. Such a format could, of course, be used for forecasting purposes as well. Commenting on the need for some form of revised financial statement format for internal decision-making purposes, Mr. Knortz stated:

Exhibit 1: ITT Corporation Discretionary Spending—1980
(Thousands of Dollars)

Operating Sources of Funds		
Net Income, Including Minority Earnings	$941,391	
Plus:		
Interest expense after tax	302,896	
Non-cash items:		
Depreciation per books	498,563	
Reserves and deferred items	(25,250)	
Sale of timber facilities	200,603	
Operating funds available		$1,918,203
Replacement and capital costs		
Depreciation per current cost basis	$(880,000)	
Cost of capital:		
Dividends at 50% of ordinary net income	(425,646)	
Interest expense after tax	(302,896)	
Minority equity	(23,505)	
Funds required		(1,632,047)
Discretionary funds available		286,156
Discretionary applications		
Working capital, excluding short-term debt	$ 45,317	
Net plant additions, beyond adjusted depreciation	(45,260)	
Equity changes in insurance and finance	(252,549)	
Dividends (over) under 50% level	66,389	
Other (investments) and divestments	48,974	
Changes in capital stock	33,439	(104,090)
Net decrease (increase) in interest-bearing debt		$ 182,066

"A P and L statement is not a financing document; it is a representation of earnings. It suggests that if I bought something for X and sold it for Y, the difference is profit. In inflation accounting, we change the X and we now have a reduced profit. But what we really are trying to do is finance the next transaction in the line. I submit that instead of having a different income statement, we really ought to be working toward a more useful financing document."

There were no further detailed presentations because the programs of the other companies represented at the forum were, for the most part, still at very early stages of their development. Nevertheless, there was considerable discussion of the problems brought to light in the company programs described above. In addition, there was much concern expressed over the problem of productivity and how to measure it. The consensus was that, at this point, nobody really knows how to quantify productivity, especially when it is brought about by technological changes.

Some concern was expressed over the fact that FAS 33 data seem to indicate that some major corporations are not earning enough (on an inflation-adjusted basis) to meet their dividend payout schedules. The feeling seemed to be that, over time, these companies are on safe ground as far as their dividends are concerned. But some of them may be unwise in failing to reserve more cash for financing purposes, instead of paying out so much to their stockholders.

CONSENSUS OF THE FORUM

Several points seemed to come through rather clearly during the discussion. For one thing, the forum participants believe quite strongly that their responsibilities as preparers and auditors of financial reports go beyond merely informing investors and the public of the effects of inflation; this requirement is satisfied, at least to some extent, by compliance with FAS 33. A much more pressing concern of the discussants is how to assist

corporate managements and boards of directors in discharging their responsibilities during inflationary times. There is no equivalent of FAS 33 to help in this effort.

Some of the panel members are experimenting with new reporting approaches and formats, as indicated in the preceding sections of this report. But few gave any indication of strong satisfaction with the results obtained so far. There seemed to be a feeling that most companies are groping in the dark—that is, if they are even aware of the need to provide management information that will be helpful in decision making during inflation. Furthermore, even those companies with such awareness are a small minority of the total population. The general feeling was that probably the majority of firms are doing little or nothing.

Two things appear to be needed to help overcome these deficiencies. One is a responsible research study that will bring to light the practices being developed by the presumably small number of firms that attempt to provide inflation-adjusted information to their executives. Such a study should concentrate on describing the state of the art in those leading-edge firms that are actually doing something. Little benefit would be derived, in the discussants' view, from a "nose count" study, for example, showing how many (or how few) firms develop inflation-adjusted information for decision-making purposes.

Even more important, in the opinion of the forum members, is the need for two kinds of educational efforts directed at managements of U.S. corporations. One facet of such an effort is to convince senior managements and boards of directors of the importance of the problem and to make them aware that it is far broader than merely presenting alternative accounting information. The second aspect of the educational requirement is to convince management at all levels that inflation-adjusted data are more valid in the present environment than the conventional, historical-cost data to which they are accustomed.

Several of the participants called attention to the pioneering efforts of General Electric Company and Professor David Hawkins of Harvard University in educating management to think in terms of inflation.

On this latter point, Mr. Leak reported that his company has enjoyed considerable success with its in-house training program. This activity ranges all the way from supervisory training courses to three-day financial seminars for senior executives. There are also five-day training sessions given twice a year for middle managers. A good portion of these programs is devoted to indoctrinating the attendees with the concepts and usefulness of the company's inflation-adjusted management system.

There was widespread agreement that it is usually very difficult to convince operating executives to accept inflation-adjusted information. In addition to upsetting long-standing thought patterns, these data are perceived as threats by many management people. The reason is, of course, that they naturally object to accounting measurements which result in lower profits for the entities under their direction because such measurements reflect unfavorably on their performance as managers. And this problem is worsened in situations where a manager's compensation is tied to the financial performance of his unit.

There were several expressions of pessimism among the forum members on two points. For one thing, the outlook for containing or reducing the spread of inflation in the economy is not considered bright, according to those who commented on this matter. The other area of pessimism had to do with the general usefulness of presenting inflation-adjusted data to readers, either outside or within the company.

As far as outside consumers of financial information are concerned, Mr. Norby observed that many financial analysts do not seem to have shown much interest in FAS 33 data so far. Another member added that his company has spent a great deal of money, programming time, and so on, to produce FAS 33 data showing that inflation-adjusted profits are much lower than those reported on the conventional basis. But he does not see that any particular benefit has resulted—either for the stockholders or for the company's management. Turning to the application of inflation adjustments to management reports, one member asked what good these adjustments will be to local managers if they are already pricing their products as aggressively as competition will allow.

In response to these objections, other members of the forum agreed that inflation-adjusted data cannot, by themselves, solve the problems of investor or management decision making under inflationary conditions; all they can do is bring peoples' attention to the real state of affairs. The main objective is to get readers of financial statements (especially managers, in the context of this meeting) to focus on *real* economic returns in the process of decision making. As one participant stated: "A company that deals properly with inflation over time will be strong regardless of which accounting measurements are used. A company that does not deal with it properly will be weakened."

Still another participant summed up: "The problem we're dealing with here is much broader than just inflation accounting. Inflation accounting is a set of techniques that have been developed to try to measure, to some degree, whatever are real results. But another aspect is the question of educating the operating managers and boards of directors of corporations. Would you consider this as a pretty good definition of the problem that we are trying to deal with?"

APPENDIX A:
INDUSTRIAL INFLATION ACCOUNTING INDEX
1973-1980

Developed by
William C. Norby, C.F.A.

NOTES

1. This index is comprised of 100 industrial companies in 23 industry categories. There are no oil or forest product companies as yet. The index is still in the process of refinement and some of the data may be subject to correction at a later date. Eventually, the base will be expanded to 110 companies. In the meantime, the data should be considered preliminary.

2. Current cost adjustments for 1980 are based on FAS 33 data; for 1979 on either FAS 33 or ASR 190, whichever was reported; for 1976-1978 on ASR 190; and for earlier years on estimates by the author. The adjustment methods employed by the reporting companies are not entirely comparable through these years, with significant discontinuities between ASR 190 and FAS 33 depreciation for six companies. FAS 33 depreciation is lower in all cases but one. Nevertheless the trends are reasonably indicative on an aggregate basis.

100 Companies
(Billions of Dollars)

INCOME ACCOUNT

	1973	1974	1975	1976	1977	1978	1979	1980
Sales	$289,807.7	$331,906.6	$349,954.9	$398,036.3	$448,824.8	$519,569.1	$586,354.1	$630,803.2
Cost of Goods Sold — Reported	200,641.3	233,754.3	247,985.5	279,674.4	318,452.4	364,541.7	422,469.7	458,045.8
Current Cost of Goods Sold	203,882.3	240,843.7	249,986.8	281,806.5	320,898.3	367,581.1	425,629.1	462,976.9
Current Cost Increment to COGS	3,241.0	7,089.4	2,001.4	2,132.2	2,446.0	3,039.5	3,159.4	4,931.2
Depreciation, Depletion, Amortization — Reported	10,339.1	11,356.9	12,314.9	13,303.4	14,781.3	16,476.3	19,141.5	21,857.8
Current Cost Depreciation	12,560.9	14,824.4	17,106.6	18,867.7	21,049.7	23,430.6	26,822.9	30,760.1
Current Cost Increment to Depreciation	2,221.8	3,467.5	4,791.7	5,564.3	6,268.3	6,954.3	7,681.4	8,902.2
Balance for fixed charges — Reported	33,418.7	33,525.3	33,901.3	42,886.0	48,059.3	57,077.3	57,289.0	53,478.8
Balance for fixed charges — Current Cost	27,955.9	22,968.3	27,108.2	35,189.6	39,385.0	47,083.5	46,448.2	39,645.4
Total Interest Expense	3,280.6	4,486.6	4,879.2	4,775.0	5,474.7	6,422.0	7,767.2	10,390.6
Pretax Income — Reported	30,138.1	29,038.7	29,022.1	38,111.1	42,624.6	50,655.3	49,521.7	43,088.2
Less: Total Current Cost Increment	5,462.8	10,557.0	6,793.1	7,696.5	8,714.3	9,993.9	10,840.8	13,833.4
Current Cost Pretax Income	24,675.3	18,481.8	22,229.0	30,414.6	33,910.3	40,661.4	38,681.0	29,254.8
Current income tax	12,713.1	11,422.7	11,825.5	15,683.6	18,558.0	20,968.3	19,652.5	15,805.5
Deferred income tax	871.5	1,574.5	1,144.1	1,371.5	750.4	1,790.4	882.8	1,714.7
Total income tax	13,584.6	12,997.2	12,969.5	17,055.1	19,299.0	22,758.8	20,534.3	17,520.2
Net income before Extraordinary Items — Reported	17,002.6	16,269.3	16,296.5	21,685.2	24,387.4	29,146.0	30,206.1	26,441.7
Current Cost Income before Extraordinary Items	11,539.8	5,712.4	9,503.5	13,988.7	15,673.1	19,152.2	19,365.4	12,608.3
Preferred dividends	220.6	239.1	235.3	237.9	259.4	261.3	365.3	445.1
Reported Net Income for Common before Extraordinary Items	16,782.0	16,030.3	16,061.2	21,447.3	24,133.2	28,884.8	29,840.9	25,861.6
"LIFO" Earnings (COGS Adjustment Only)	13,541.0	8,940.9	14,059.9	19,315.2	21,687.2	25,845.2	26,681.4	20,930.4
Current Cost Net Income for Common	11,319.2	5,473.3	9,268.1	13,750.9	15,418.8	18,890.9	19,000.1	12,028.2
Reported Net Income for Common after Extraordinary Items	17,034.1	16,298.2	16,426.1	21,721.8	24,384.3	29,453.8	29,914.5	26,792.5
Dividends on Common	6,945.3	7,061.3	7,085.4	8,761.3	10,418.3	11,465.4	12,768.2	12,993.4
Retained Net Increment — Reported (before Extraordinary Items)	9,836.7	8,969.0	8,975.8	12,686.0	13,714.9	17,419.3	17,072.7	12,868.2
Current Cost Retained Net Income (before Extraordinary Items)	4,373.9	−1,588.0	2,182.7	4,989.5	5,000.6	7,425.5	6,231.9	−965.3
Holding gain — inventory	4,668.1	12,305.8	3,518.2	4,400.2	4,750.5	6,404.6	9,380.8	9,895.4
Holding gain — plant and equipment	7,906.8	22,240.2	16,078.9	16,540.1	14,388.2	22,400.2	14,497.0	27,741.8
Economic Income	24,114.7	40,258.4	29,100.6	34,929.0	34,811.8	47,956.9	43,243.1	50,245.5